Financial Report

Analysis of Operating Expenses and External Management Fees

Operating expenses represent the Caisse's total portfolio management and administration costs. External management fees are amounts paid to external financial institutions to manage funds on the Caisse's behalf. Operating expenses include expenditures for the management of the Real Estate and Real Estate Debt portfolios. Operating expenses related to the management and administration of real estate assets and mortgages are deducted from real estate investment income and mortgage income, respectively.

For fiscal year 2011, operating expenses totaled $269 million, a $12 million increase over 2010, partially due to the recruitment of resources to strengthen the information technology and research sectors. However, bringing strategic IT organization functions in-house, as was announced last year, and simplifying procedures, enabled the Caisse to save close to $25 million.

External management fees totaled $9 million, lower than the $12 million figure reported in 2010. Fees for external management are claimed as a deduction against investment income.

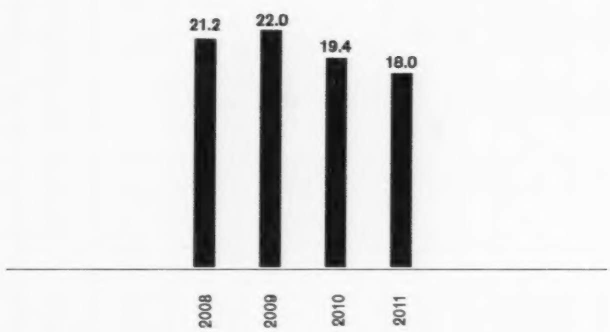
Operating expenses and external management fees amounted to $278 million in 2011, up $9 million or 3.3% from $269 million in 2010. This represents 18 cents per $100 of average net assets, placing the Caisse among the leading institutional fund managers (see Figure 68).

OPERATIONAL EFFICIENCY

The Caisse periodically reviews its procedures to maintain strict control over its operating expenses. It aims to keep operating expenses at a level that, given the composition of its investments, is favourably comparable to that of same-size institutional fund managers with similar operations. For many years, the Caisse has been benchmarking its costs by asset class. Generally, its total costs compare favourably with those of its peers.

FIGURE 68

OPERATING EXPENSES AND EXTERNAL MANAGEMENT FEES EXPRESSED IN CENTS PER $100 OF DEPOSITORS' AVERAGE NET ASSETS
(for periods ended December 31 – in cents)



CONSOLIDATION OF THE OPERATIONAL AND INFORMATION TECHNOLOGY BUSINESS MODEL

In 2011, the Caisse continued its efforts to consolidate its business model, among other things by implementing a model of governance and integrated processes for Operations and IT, and by moving to a new outsourcing contract for IT services that is aligned with the new business model and more open to technology market opportunities.

The Caisse has acquired an enterprise architecture and has completed some important work, including:

- a new-generation system for managing liquid market portfolios;
- the complete integration of all private equity products in a single specialized system;
- the establishment of the bases for simplified data access by setting up the Caisse data warehouse.

The Caisse has also developed a new information security policy and a master plan for implementing it. As well, it enhanced its general IT controls by adopting the internationally renowned CobiT 5.0 governance and management model.

CDP Financial

CDP Financial, a wholly owned subsidiary of the Caisse, enters into financing transactions in local and international institutional markets by issuing commercial paper and term notes. These transactions are aimed at optimizing the financing costs of the Caisse's activities and its subsidiaries, providing greater financing source diversification.

HIGHLIGHTS

01 The fair value of borrowings of CDP Financial totaled $9.8 billion, confirming a year of stability.

02 Credit rating agencies reaffirmed investment grade credit ratings with a stable outlook, namely AAA (DBRS), AAA (S&P) and Aaa (Moody's) – to the Caisse and CDP Financial.

SHORT-TERM BORROWINGS

The fair value of short-term financing transactions in the Canadian market stood at $1.0 billion as at December 31, 2011, equivalent to the level as at December 31, 2010 (see Figure 69). The average maturity of the borrowings was 77 days in 2011, for transactions totaling $4.8 billion.

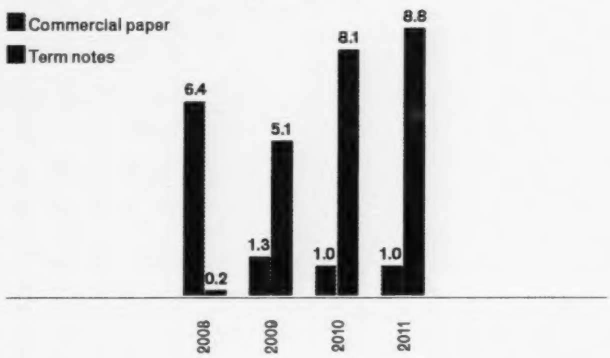
TERM BORROWINGS

As at December 31, 2011, CDP Financial's outstanding term notes totaled $8.8 billion. The $700 million increase over 2010 is due to the impact on fair value of the drop in interest rates (see Figure 69). The outstanding notes were issued between 2009 and 2010 on Canadian, U.S. and European markets. The financing program made it possible to substitute a portion of short-term debt with longer-term debt in order to ensure matching of the financing and financed asset terms. As a result of this program, the renewal risk of the financing decreased, as did the need for currency hedging, since the term borrowings financed assets denominated in the same currency.

FIGURE 69

BREAKDOWN OF LIABILITIES – CDP FINANCIAL

(fair value as at December 31 – in billions of dollars)

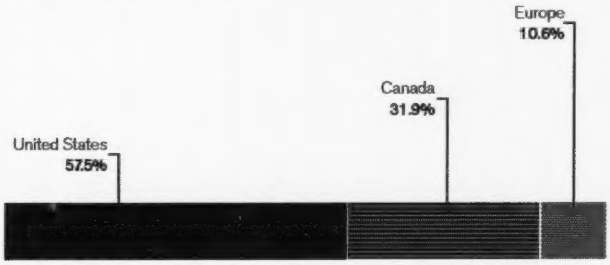


CDP Financial

FIGURE 70

GEOGRAPHIC BREAKDOWN OF LIABILITIES – CDP FINANCIAL

(fair value as at December 31, 2011)



The geographic distribution of financing transactions remained stable during 2011. The debt issued on the U.S. market dominated at 57.5%, followed by the Canadian market at 31.9% and by the European market at 10.6%, as shown in Figure 70. Debt is matched to assets in the same currency.

FINANCIAL FOUNDATIONS REMAIN SOLID

Credit rating agencies Dominion Bond Rating Service (DBRS), Moody's Investors Service (Moody's) and Standard & Poor's (S&P) maintained their investment grade credit rating with a stable outlook. These credit ratings are the highest issued by these rating agencies (see Table 71).

- On November 7, 2011, S&P confirmed the Caisse's short- and long-term credit ratings with a stable outlook.
- On November 25, 2011, DBRS issued an update confirming the short- and long-term credit ratings of the Caisse and its subsidiary, CDP Financial, with a stable outlook.
- On February 21, 2012, Moody's issued an update confirming CDP Financial's short- and long-term credit ratings, and maintained a stable outlook.

TABLE 71

CREDIT RATINGS

	Short-term	Long-term
DBRS	R-1 (HIGH)	AAA
Moody's	PRIME-1 (Aaa)	Aaa
S&P	A-1 + A-1 (HIGH)	AAA

Critical Accounting Policies

The financial statements of the Caisse de dépôt et placement du Québec are combined: they include the accounts of the Caisse's subsidiaries, the General Fund, individual funds and specialized portfolios. Depositors' holdings reported in the Combined Statement of Net Assets reflect the combination of each Caisse depositor's net account value.

Note 2 accompanying the audited Combined Financial Statements as at December 31, 2011 describes the significant accounting policies used by the Caisse. Some of these accounting policies involve subjective and complex judgments and estimates. Any changes to these judgments and estimates could have a significant impact on the Caisse's Combined Financial Statements.

CHANGEOVER TO INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

In 2008, the Accounting Standards Board (AcSB) confirmed that Canadian generally accepted accounting principles (GAAP) would be replaced by International Financial Reporting Standards (IFRS) for all publicly accountable entities, effective January 1, 2011. The Caisse is defined as a publicly accountable entity.

In August 2011, the International Accounting Standards Board (IASB) finally published its exposure draft on investment entities (investment companies). The Caisse responded to this exposure draft to the IASB and AcSB in December and took part in several meetings with these organizations throughout the year. The IASB plans to publish the standard in late 2012 or early 2013.

The Caisse, working closely with its co-auditors, will continue to monitor developments involving this exposure draft and other standards, and will frequently review its preliminary conclusions so it can determine the other consequences for its combined financial statements.

In December 2011, the AcSB again decided to defer the adoption of IFRS for investment companies that apply the Accounting Guideline AcG-18, "Investment Companies," of the Canadian Institute of Chartered Accountants (CICA) Handbook, due to the delay in the IASB's publication of a standard covering investment companies. Since the Caisse is an investment company, the mandatory date of its changeover to IFRS has been deferred to January 1, 2014. Thus, the Caisse's Audit Committee approved the recommendation based on which the Caisse would prepare its Combined Financial Statements in accordance with IFRS starting in 2014.

EXTERNAL AUDIT

The Caisse's financial statements are prepared in accordance with Canadian generally accepted accounting principles, complying with the Act respecting the Caisse de dépôt et placement du Québec.

As required by law, the Caisse's co-auditors audited the institution's accounting records for fiscal year 2011 and issued their reports on the Caisse's financial statements. Overall, the co-auditors reported on 54 financial statements, namely the Caisse's Combined Financial Statements and those of the General Fund, 35 individual funds of the depositors and 17 specialized portfolios. They issued an auditors' report without modification for each of these financial statements.

Fair Value Measurement

Investment valuation is a process whereby a value is assigned to each investment of the Caisse in preparing its financial statements. The valuation of investments at fair value is performed periodically according to policies and processes specific to each type of investment. These procedures comply with the standards and practices of Canadian and international organizations, involving the use of stock market, valuator or independent expert valuations. The co-auditors have access to all major valuation files as part of their audit of year-end financial statements.

ACCOUNTING PROVISIONS

According to CICA Handbook Accounting Guideline AcG-18, "Investment Companies," the Caisse must determine the fair value of its investments based on the assumption that they are available for sale on the preparation date of its financial statements. This accounting guidance draws heavily on recent international developments in fair value measurement accounting standards. The purpose of these standards is to define a conceptual framework for all standards that require fair value measurement.

Under normal circumstances, the fair value (mark-to-market) rule is not a problem since all financial markets are active and investment values can be based on actual transactions involving comparable assets in various markets. However, when markets are disrupted (i.e. there are no purchases or sales), fair value must be determined by a financial model based on discounted cash flows (mark-to-model) whose parameters, namely financing and illiquidity premiums, are exposed to a certain level of subjectivity from firm to firm or valuator to valuator. The higher the premiums, the lower the fair value of the investments.

IMPACT ON THE CAISSE'S INVESTMENTS

The Caisse believes that these standards provide a coherent framework, but must be applied with discretion. These highly restrictive standards ignore the fact that, given the very long investment horizon adopted by its major depositors, the Caisse has the resources and intent to hold certain investments until their optimal value is reached.

As a result, the fair value determined as at December 31, 2011, for illiquid market investments, such as real estate, private equity, infrastructure, commercial debt and commercial mortgages, reflects the overall volatility of financial markets, which may deviate from the economic value of long-term holdings.

ESTABLISHING FAIR VALUE AT THE CAISSE

Liquid investments

The fair value of liquid investments is based on major stock market quotes, dealer or other specialized agency ratings or inputs and recognized capital market valuation methods, such as discounting future cash flows at the current interest rate. Quarterly, certain portfolios, and, semi-annually, all portfolios of unlisted liquid products are valued by independent professionals. These products, which include bonds and over-the-counter derivatives, are valued on both a valuation model and input basis.

Illiquid investments

Private equity and infrastructure

The fair value of private equity and infrastructure investments is determined semi-annually, at June 30 and December 31, unless significant circumstances require a change in value of an investment at another time during the year. The valuation is based on a policy, adopted by the Caisse's Board of Directors, which draws on the industry's best practices. The policy enables managers to value their private equity investments before approval by the Private Equity group's management.

Investments whose fair value exceeds a predetermined materiality threshold must be submitted to an independent valuation committee or an external independent valuator. The committee, which reports to the Caisse's Audit Committee, is composed of independent valuation professionals. The co-auditors attend the committee's meetings as observers. The process is complemented internally by regular and timely valuations, as events occur.

Real estate investments

The fair value of real estate investments is determined semi-annually, at June 30 and December 31, unless significant circumstances require a one-time investment valuation adjustment. The valuation of the Real Estate portfolio's investments is based on a policy adopted by the Caisse's Board of Directors. The policy draws on the industry's best practices. The fair value of the Real Estate portfolio's assets is certified by external chartered valuators. The fair value of other real estate investments is largely determined by external managers. Internal managers determine the fair value of debt associated with real estate investments. In addition, the real estate subsidiaries' external auditors audit fair values in preparing audited financial statements.

The fair value of mortgage loans and securities is based on the discounted value of future contractual cash flows at the market interest rate. This is the rate that could be obtained for loans or securities with similar terms and maturities. In cases where the timing of cash flows cannot be estimated with reasonable reliability, fair value is either the fair value of any asset given as collateral, net of expected costs of realization and any amount legally owed to borrowers, or the security's relevant market price. The Caisse relies on an independent professional valuation.

ABTNs

Asset-backed term notes (ABTNs) are financial instruments with an average maturity of five years. To provide an economic hedge to reduce the risk of loss inherent in ABTNs' fair value changes and possible collateral calls, the Caisse uses financial derivatives such as credit default and interest rate swaps.

MAV 1 ABTNs and certain ABTNs excluded from the restructuring agreement are essentially composed of credit default swaps. The fair value of the credit default swaps is established using valuation techniques that are based as much as possible on observable market data such as rate spreads, correlation factors and an illiquidity premium, which is calculated from the spread between the bid and ask prices of similar financial instruments traded on the market. For the other ABTNs, the Caisse established fair values using a valuation technique based on a financial model whose assumptions use observable market data, such as interest rates and credit quality, as much as possible. In addition, a favourable court judgment was handed down in the fall of 2011 in a case involving an ABTN excluded from the restructuring agreement. Following an analysis of the conclusions set out in this judgment, the Caisse considered this favourable development in determining the fair value of the related investment.

The fair value of the ABTNs as at December 31, 2011, was reviewed by an independent firm.